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How States Should Now Consider Expanding Sales Taxes to Services, Part 2

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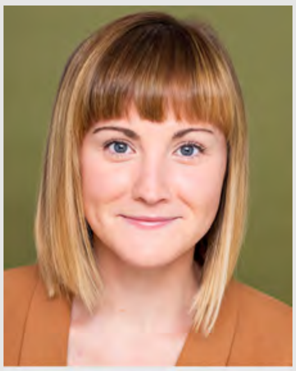

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In this installment of Academic Perspectives on SALT, the authors explain some of the implementation details and options for how states might go about expanding their sales tax bases to include services.

As we explained in our prior essay,[1] state governments are experiencing severe revenue needs because of COVID-19, and expanding state sales tax bases to include services is a promising option for state governments to manage their budget shortfalls. In this, the second essay in this series — a contribution to Project SAFE: State Action in Fiscal Emergencies — we explain some of the implementation details and options for how states might go about expanding their sales tax bases to include services. In particular, we argue that there are some incremental steps that seem to be technically and politically feasible as responses to the current crisis.[2] In particular, we argue the states should start by expanding their sales taxes to include services that are least problematic as a matter of policy and politics.

Which Services to Tax

If states decide to expand their sales tax bases to include more services, they will need to determine which services to bring under the sales tax umbrella. Services can be divided into roughly three categories: services consumed primarily by businesses, services consumed primarily by households, and services consumed by both businesses and households.

Economists generally agree that states should not tax business-to-business transactions, in order to avoid "tax pyramiding" — when businesses raise prices to cover taxes paid on intermediate

[1] Shobe et al., "Why States Should Consider Expanding Sales Taxes to Services, Part 1," *Tax Notes State*, Dec. 21, 2020, p. 1349.

[2] This is not to say that we would necessarily oppose more sweeping reforms to U.S. consumption taxation of the types outlined recently in Karl A. Frieden and Douglas L. Lindholm, "U.S. State Sales Tax Systems: Inefficient, Ineffective, and Obsolete," *Tax Notes State*, Nov. 30, 2020, p. 895, but agree that such reforms seem unlikely in the short term. We are more optimistic than Frieden and Lindholm about the possibility of meaningful incremental reforms. *Cf. id.* at 934-35.

transactions during production.[3] Furthermore, taxing business inputs distorts the allocation of resources by encouraging businesses to provide those services in house, even if those services could be produced more efficiently by a third party.[4] Therefore, states that choose to expand their sales tax bases should proceed cautiously regarding services consumed primarily by businesses.[5] As we will elaborate in our planned third essay in this series, rather than trying to exclude categories of services from sales tax bases because these services are often (but not always) consumed by businesses, the best path may be to add a credit, deduction, or exemption for business-to-business sales. But if politics or other obstacles prevent the adoption of such a credit, deduction, or exemption, it may be prudent to partially or fully exempt services primarily consumed by businesses.

By contrast, policymakers generally support taxing services consumed by households.[6] The purpose of a sales tax is to tax personal consumption, and the consumption of services by households, such as lawn care services for a home or the services of a personal trainer, is a form of personal consumption. According to a survey by the Federation of Tax Administrators, although a handful of states tax more than 100 services (for example, Hawaii taxes 167 services and New Mexico taxes 164), most states tax far fewer.[7] Many of the untaxed services are consumed primarily by individuals, including household storage, dating services, gyms, tanning and hair salons, and personal instruction (like golf lessons or fitness coaching).[8]

The third category of services includes services consumed by both businesses and households. This category is obviously more complicated because states would need to find ways to capture personal, but not business, consumption of these services. For all three categories, the best way to accomplish this goal is by granting deductions for intermediate business transactions or reforming the current system of business-to-business credits, rather than trying to exclude categories of services from sales tax bases, since these services are often (but not always) consumed by businesses. This essential design feature is the subject of our planned third essay in this series.

Mechanics of Expanding the Sales Tax Base

Over the last 35 years, many state legislatures have proposed expanding their sales tax bases to broadly capture services.[9] Many have failed. For example, Utah (2019) and Maryland (2020) legislators proposed significantly expanding their sales tax bases to include more services, but the local business communities mobilized against and defeated the proposals.[10] Similarly, when Michigan tried to tax a long list of enumerated

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[3] *See* Cline et al., "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," *State Tax Notes*, Feb. 14, 2005, p. 457; *see generally* Jared Walczak, "2020 State Business Tax Climate Index," Tax Foundation, 35-36 (Oct. 21, 2019) (scoring states based on their tax systems and giving the worst sales tax scores to states that tax the most business inputs).

[4] Despite the arguments against imposing sales taxes on business inputs, states collect an average of 42 percent of their sales tax revenue from business inputs. *See* Frieden and Fred Nicely, "The Best and Worst Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity & the Exemption of Business Inputs," Council On State Taxation, 9 (Apr. 2018).

[5] It is worth noting that although states should avoid expanding the number of business-to-business services in their tax base, business inputs currently make up a significant portion of many states' sales tax base. *See* Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 12.03 (3d. ed. July 2020) ("Business inputs in fact make up a healthy portion of most states' sales tax bases. Indeed, several nationwide studies conclude that business inputs as a share of the sales-tax base average about 40 percent for forty-five states and the District of Columbia.").

[6] *See, e.g.*, Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities (July 2009).

[7] *See* Federation of Tax Administrators, "FTA Survey of Services Taxation — Update" (July-Aug. 2017), at 1.

[8] *See id.*; *see also* Nicole Kaeding, "Sales Tax Base Broadening: Right-Sizing a State Sales Tax," Tax Foundation, at tbl.3 (Oct. 24, 2017); and Mazerov, *supra* note 6, at 38-43.

[9] *See, e.g.*, Fla. Stat. section 212.059 (1987), *repealed by* 1988 Fla. Laws 19; Fla. S.J.R. 938 (2002) (never passed); Mass. Gen. L. ch. 64H, sections 1-33 (1991), *amended and partially repealed by* 1991 Mass. Acts 4; Mass. Gen L. ch. 64H, section 1 (amending the sales tax to include "computer system design services") (2013), *repealed by* 2013 Mass. Acts ch. 95; 2007 Mich. Pub. Acts 92, *repealed by* H.B. 5408, 94th Leg., Reg. Sess. (Mich. 2007); *see also, e.g.*, Indiana Fiscal Policy Institute, "Sales Taxation of Services in Indiana: Concepts and Issues," 6-7 (2009) (describing unsuccessful attempts to expand service taxes in Florida, Maryland, Massachusetts, and Michigan, but noting New Jersey's successful but significantly more narrow expansion of taxable services).

[10] H.B. 441, 63d Leg., Gen. Sess. (Utah 2019) (bill not passed); *see, e.g.*, Lisa Riley Roche, "Despite Business Backlash, Utah's Tax Reform Bill Headed to House Floor," *Deseret News*, Mar. 1, 2019; Utah Association of Certified Public Accountants, "Urgent: We Need Your Help With H.B. 441" (Mar. 2, 2019) ("With a tax on professional services we could potentially invite an out-migration of business and uninvite businesses that are currently looking to relocate to Utah."); Pamela Wood, "Maryland Lawmakers Defeat Sales Tax Expansion That Was Pitched as Way to Pay State's Share of Kirwan Education Improvements," *Baltimore Sun*, Mar. 5, 2020; and Ovetta Wiggins, "5,000 Emails in 3 Hours: Blast of Opposition to Md. Bill Expanding Sales Tax," *The Washington Post*, Mar. 3, 2020.

services in 2007, "widespread public opposition" caused the Legislature to repeal the tax on the day it was scheduled to go into effect.[11] Additional examples of states that have proposed, but failed to pass, legislation that would have added services to their sales tax base include Florida (1987 and again in 2002), Massachusetts (1991), Nebraska (2013), Ohio (2013), Louisiana (2013), Minnesota (2013), and Pennsylvania (2015).[12]

In contrast, several states have successfully expanded their sales tax bases over the past decade. For example, Connecticut increased the number of services in its sales tax base from 85 to 99, the District of Columbia expanded its services tax base from 75 to 91, North Carolina increased its list of taxable services from 36 to 62, and Kentucky added an additional 17 services in 2018.[13] Health clubs, home maintenance services, dry cleaning, automotive repair, car washes, parking lots, storage, carpet cleaning, bowling alleys, and pet services were among the many services added to these states' tax bases. These examples show that although expanding a state's tax base to include services may be politically difficult, it is still possible.

Why have some states been able to successfully expand their sales tax bases to include services while others have failed? Many factors determine whether a bill is successful. For example, states' current sales taxes often capture goods (like auto parts) but not adjacent services (like mechanics' services), which can create economic distortions by treating closely related transactions differently.[14] When state legislatures add new items to the sales tax base, additions that reduce these distinctions may prove more politically feasible and easier to administer, in part because they likely affect vendors who are already collecting and remitting sales tax.

Another factor that appears to affect the outcome is whether the proposed legislation taxes business inputs. States that include business-to-business service transactions in their proposed bills provoke strong opposition from the states' business communities, which argue that the proposed legislation will result in tax pyramiding.[15] For example, Michigan's proposed legislation faced strong opposition because it would have captured many services used primarily by businesses, like management, scientific, and technical consulting; office administration; merchandise warehousing and storage; and industrial and graphic design.[16] Proposed legislation in Florida, Louisiana, Massachusetts, Minnesota, Ohio, Nebraska, and Utah faced similar defeat after their business communities argued that the bills would have taxed business inputs.[17] In contrast, the District of Columbia and states that have successfully added services to their tax base have primarily added personal services, not business inputs.[18] Although they also were opposed by some interest groups, such as health clubs, they also received support from policymakers who argued that the bills targeted personal consumption and were thus

[11] Monica Davey, "States Seeking Cash Hope to Expand Taxes to Services," *The New York Times*, Mar. 27, 2010; and H.B. 5198, 94th Leg., Reg. Sess. (Mich. 2007) (adding a long list of both consumer and business services to Michigan's use tax base by adding section 3(d)), *repealed by* H.B. 5408 (Mich. 2007).

[12] *See* Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," EY LLP (May 2019), at 16, prepared for the State Tax Research Institute and COST; *see also* Mass. Gen. L. ch. 64H, sections 1-33 (1991), *amended and partially repealed by* 1991 Mass. Acts 4; Samuel B. Bruskin and Kathleen King Parker, "State Sales Taxation on Services: Massachusetts as a Case Study," 54 *Tax L.* 49 (1991) (detailing and analyzing Massachusetts's attempt to tax a long list of services); Fla. Stat. section 212.059 (1987), *repealed by* 1988 Fla. Laws 19; Fla. S.J.R. 938 (2002) (never passed); and Vicki L. Weber, "Florida's Fleeting Sales Tax on Services," 15 *Fla. St. U.L. Rev.* 613 (1987).

[13] *See* FTA Survey of Services Taxation — Update, *supra* note 7; and Chicago Metropolitan Agency for Planning, "The Benefits of Adding More Services to Illinois' Sales Tax Base," 6 (Mar. 5, 2019).

[14] *See supra* note 1.

[15] Phillips and Ibaid, *supra* note 12, at 18 ("Each of these proposals failed, in large part due to opposition from the business community. Generally, the policy objections were not to the expansion and modernization of the sales tax base to include the growing services sector, but to doing so without limiting the base expansion to household services.").

[16] H.B. 5198, 94th Leg., Reg. Sess. (Mich. 2007) (incorporating specific industry codes from the 2002 North American Industry Classification System by reference, including codes 5416, 5611, 4931, and 5414).

[17] *See* Phillips and Ibaid, *supra* note 12, at 16; Weber, *supra* note 12, at 626, 628 (explaining that under the 1987 Florida law, all services purchased by nearly all businesses would be subject to sales tax); Michele E. Hendrix and George R. Zodrow, "Sales Taxation of Services: An Economic Perspective," 30 *Fla. St. U.L. Rev.* 411, 416 (2003), at 427-28 (stating that the 2007 Florida proposal would have "expand[ed] the tax base to include a wide variety of both consumer and business services" and provided "limited exceptions" for business-to-business transactions); and H.B. 441, 63d Leg., Gen. Sess. (Utah 2019) (exempting manufacturing, wholesale trade, and most financial services, but providing no exemption for legal, accounting, and most architectural and engineering services). Massachusetts's 1991 law would have taxed professional services like legal, accounting, engineering, and architectural services *only* when provided to businesses, not individual consumers. 1990 Mass. Acts ch. 121 section 42 (defining many "services" for consumption tax purposes to include services *only* if "provided to businesses").

[18] *See* FTA Survey of Services Taxation — Update, *supra* note 7.

grounded in sound tax policy.[19] Therefore, while there are certainly many factors that affect the outcome of any proposed bill, it appears that legislation that avoids taxing business-to-business transactions is more likely to pass.[20]

State legislatures that hope to successfully pass this type of legislation might also consider waiting to tax service industries that have suffered large losses because of the economic effects of COVID-19 (for example, hair cutting services), at least until those industries have had an opportunity to recover. One solution to this could be to shift to a fuller tax base in two phases. Phase 1 could primarily focus on digital services,[21] which have generally profited despite the economic devastation of the pandemic because digital services are, by nature, consumed remotely.[22] For example, demand for digital streaming services such as Netflix, Hulu, Disney+, HBO Max, and Amazon Prime Video increased during the pandemic, yet only 22 states tax streamed video or audio media.[23] And even the states that do tax some form of digital services generally capture only a fraction of the potential digital services tax base.

Phase 2 would entail adding non-digital services to a state's sales tax base. State legislatures could propose phase 1 legislation first and wait until the economy has recovered to propose phase 2 legislation, which would have the benefit of minimizing interest group opposition to each piece of legislation. Or state legislatures could package the two phases together but choose a later effective date for imposing the phase 2 taxes, which would likely result in greater political resistance upfront but have the benefit of assuring states of future revenue streams. And to commit themselves to implementing the phase 2 expansion and make additional funds available in early years, state legislatures may also consider securitizing a portion of the phase 2 revenue.

State legislatures will also need to determine whether to expand their sales tax bases by switching from an "incremental" approach to a "comprehensive" approach. Most states take an incremental approach to taxing services, meaning they exempt services from sales tax by default and then subject specific services to sales tax by state statute.[24] In contrast, a small minority of states — including Hawaii, New Mexico, South Dakota, and West Virginia — take a comprehensive approach by taxing all services by default and then granting exemptions, such as exemptions for business-to-business transactions and essential services.[25]

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[19] *See, e.g.*, Joseph Bishop-Henchman, "Vida Fitness Spreads Half-Truths About D.C. Tax Cut Bill," Tax Foundation (May 30, 2014).

[20] This is another reason why our planned third essay will evaluate options for incorporating a credit, deduction, or exemption approach for excluding business-to-business sales.

[21] States can avoid constitutional challenges and potential violations of the Internet Tax Freedom Act by not disproportionately taxing out-of-state and foreign companies or charging higher taxes on digital services than similar services provided through other mediums. *See* Ruth Mason, "Maryland's Proposed Digital Tax May Be Unconstitutional," Medium (Jan. 30, 2020).

[22] *See, e.g.*, Dana Mattioli, "Big Tech Companies Reap Gains as COVID-19 Fuels Shift in Demand," *The Wall Street Journal*, Oct. 29, 2020; and Estefan Hernandez Escoto, "Sales Tax Policy in a Pandemic: Exemptions for Digital Goods and Services Are More Outdated Than Ever," Institute on Taxation and Economic Policy: Just Taxes Blog (Apr. 29, 2020) (arguing for taxing digital services to make up for pandemic-related lost state revenue). For further discussion of why states should tax digital services and which digital services they could tax, see generally Orly Mazur and Adam Thimmesch, "Closing the Digital Divide in State Taxation: A Consumption Tax Agenda," *Tax Notes State*, Nov. 30, 2020, p. 961; and Mazerov, "States Should Embrace 21st Century Economy by Extending Sales Taxes to Digital Goods and Services," CBPP (Dec. 13, 2020).

[23] Greg Iacurci, "The Netflix and Spotify Tax: States Are Making Streaming Services More Expensive," CNBC (Feb. 24, 2020); and David Brunori et al., "States Likely to Turn to Digital Taxes to Cover Mounting Shortfalls," RSM US LLP (Apr. 24, 2020).

[24] Typically, those states' retail sales tax regimes capture all sales of tangible personal property by default unless expressly exempted and then include a list of taxable services in the statutory definition of retail sale. *See, e.g.*, Wash. Rev. Code section 82.04.050(1)(a) (2017) ("'Sale at retail' or 'retail sale' means every sale of tangible personal property."); and Wash. Rev. Code 82.04.050(2) (2017) (providing that "'retail sale' includes the sale of . . . labor and services rendered in respect to . . . [t]he installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers," "cleaning, fumigating, razing, or moving of existing buildings," "automobile towing," and so forth).

[25] Hawaii, New Mexico, and South Dakota impose gross receipts taxes on businesses that provide services. Haw. Rev. Stat. section 273-13 (4 percent tax on "gross proceeds of sales, or gross income" of service businesses); N.M. Stat. Ann. section 7-9-3.5(1) and 7-9-4 (5.125 percent tax on "gross receipts is imposed on any person engaging in business in New Mexico," and "'gross receipts' means total amount of money or the value of other consideration received from selling property . . . or services" in the state); S.D. Codified Laws sections 10-45-2, 10-45-4, 10-45-4.1, and 10-45-5 (4.5 percent tax on "gross receipts of all sales of tangible personal property" and "the gross receipts of any person from the engaging or continuing in the practice of any business . . . unless the service is specifically exempted"); and S.D. Codified Laws section 10-45-12.1 (2020) (expressly exempting healthcare, education, and local transportation (except for limousines!)). Although the tax is paid by businesses, not the consumer, the end result — a consumption tax on services — is the same, since businesses will pass the gross receipts tax costs on to consumers through higher prices. West Virginia includes services in its retail sales tax base, but it exempts all "professional services." W. Va. Code sections 11-15-2 and 11-15-3.

Although the comprehensive approach naturally captures more services in a state's sales tax base, and is superior on policy grounds, seemingly making it the most attractive option for capturing a broad range of services, only South Dakota has successfully switched from an incremental to a comprehensive approach. Every other state's attempt to make this switch has been defeated, in large part because the business community has argued that a comprehensive approach sweeps a large number of business inputs into the tax base.[26] Thus, it may well be that taking an incremental approach is more politically achievable than aiming for a more ambitious, comprehensive one. For guidance on navigating the political obstacles, state governments might look to jurisdictions that have successfully implemented the incremental approach, like Connecticut, Kentucky, North Carolina, and the District of Columbia.[27]

Conclusion

Most states could add significant revenue to their tax bases by taxing services at a time when additional revenue is sorely needed. But state governments should be careful to avoid taxing business inputs, as our planned third essay in this series will elaborate. Also, state governments might consider delaying taxing services that were harmed by the pandemic. Although any proposal for new taxes will face resistance from the affected constituencies, proposals that are careful to tax personal consumption are more likely to succeed and could help states close budget gaps while minimizing spending cuts that disproportionately affect vulnerable populations. ■

[26] *See* Phillips and Ibaid, *supra* note 12.

[27] *See* FTA, "Survey of Services Taxation — Update," *supra* note 7.